DEPARTMENT OF STATE REVENUE

02-20160417.LOF

Letter of Findings: 02-20160417
Corporate Income Tax
For the Years 2011 through 2013

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Manufacturing Company failed to demonstrate that it was entitled to deduct interest expenses from income earned in Indiana because the loan transactions at issue with its parent company did not constitute bona fide debt for income tax purposes.

ISSUE

I. Corporate Income Tax - Interest Expense Deduction.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; I.R.C. § 162; I.R.C. § 163; I.R.C. § 385; I.R.C. § 482; *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc*., 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue,* 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Welch v. Helvering* 290 U.S. 111 (1933); *Winn-Dixie Stores, Inc. v. C.I.R.*, 254 F.3d 1313 (11th Cir. 2001); *Lewis v. C. I. R.*, 328 F.2d 634(7th Cir. 1964); *Charter Wire, Inc. v. U.S.*, 309 F.2d 878 (7th Cir. 1962); *Parkhill v. United States*, 385 F. Supp. 204 (N.D. Tex. 1974); *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987); Treas. Reg. § 1.385-1; Treas. Reg. § 1.482-2.

Taxpayer protests the Department's proposed assessments.

STATEMENT OF FACTS

Taxpayer is an out-of-state multinational corporation doing business in Indiana and outside of Indiana. Taxpayer is a specialty-packaging manufacturer of paper tableware including plates, bowls, and cups. Taxpayer has two Indiana manufacturing locations. On December 21, 2011, Taxpayer declared a dividend of $435,000,000 to its parent company, Taxpayer's sole shareholder ("Parent"). The dividend was payable on or before December 21, 2011. The dividend was not paid in cash, but was in the form of three separate credit agreements comprised of five promissory notes executed by Taxpayer as maker to Parent as lender. The same individuals signed the documents as officers on behalf of Taxpayer and Parent. On the same date, the five promissory notes were assigned to a foreign affiliate of Taxpayer ("Foreign Affiliate"). Thus, as a result, Taxpayer began making all principal and interest payments in 2012 and 2013 to the Foreign Affiliate, not the Parent. Taxpayer subsequently deducted the interest expenses, which ultimately reduced its taxable income.

The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayer's business records for tax years 2011 through 2013. Pursuant to the audit, the Department made various adjustments which resulted in additional tax assessed to Taxpayer. Taxpayer protested. An administrative hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Corporate Income Tax - Interest Expense Deduction.

DISCUSSION

As a threshold issue, all tax assessments are *prima facie* evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue,* 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc*., 963 N.E.2d 463, 466 (Ind. 2012). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *see also Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Also, "all statutes are presumptively constitutional." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 587 (Ind. 2014) (*citing UACC Midwest, Inc. v. Indiana Dep't of State Rev.* 629 N.E.2d 1295, 1299 (Ind. Tax Ct. 1994)). When an agency is charged with enforcing a statute, the jurisprudence defers the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Caterpillar, Inc.*, 15 N.E.3d at 583.

Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. IC § 6-3-2-1(b). Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine a corporation's tax liability.

During the audit, the Department determined that Taxpayer improperly reported its income. As provided in the audit report:

> The 2012 and 2013 interest expense (listed as inter-company interest on the federal pro forma income tax returns provided by the taxpayer) is not considered an ordinary business expense under [I.R.C.] section 63. Therefore, the 2012 and 2013 interest from these loans to arrive at federal taxable income is being added back pursuant to IC [§] 6-3-1-3.5(b) and 45 IAC 3.1-1-8.

The audit report cited to IC § 6-3-2-2(m), which states that "[i]n the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers." The Department's audit disallowed Taxpayer's 2012 and 2013 interest expense to fairly reflect the income from Indiana sources.

The audit report based its conclusions on three factors. First, the audit report noted that, for 2011, Taxpayer had no accumulated earnings and profits and only a small current year profit as compared to the dividend declared. The auditor therefore found that the corporate distribution was not a dividend, but a return of capital. As dividends and/or the return of capital, they are not deductible in calculating taxable income. The audit report further concluded that this transaction shifted income out of Taxpayer to Foreign Affiliate, thus reducing Taxpayer's income subject to tax in Indiana.

Second, the audit report concluded that the declared dividend action does not meet the arm's length standard under Treasury Regulation 1.482-1(b), "as it is not likely that an uncontrolled taxpayer would declare a dividend without having earnings and profits from which to pay the dividend." The audit report further found that, prior to declaring the $435,000,000 dividend, Parent made a capital contribution in the amount of $230,000,000 as forgiveness and discharge of an existing loan. The audit report concluded that this fact further supports that the loans fail to meet the arm's length standard, "as no reasonable, unrelated lender would issue new loans following the forgiveness and discharge of such a large debt."

Finally, the audit report concluded that the transactions lacked economic substance and had no business purpose aside from shifting income to a foreign affiliate and creating interest expense deductions. The auditor found that Taxpayer declared a dividend when it had no accumulated earnings and profits, and therefore created the loans to pay this dividend out over several years. The audit report concluded that "what was declared was not actually a dividend," but a "distribution considered a return of capital." There was no prospect for economic gain because income was shifted from Taxpayer to Foreign Affiliate. With respect to the business purpose, the audit concluded there was no business purpose because the transaction weakened Taxpayer's financial structure by increasing its debt and expenses, creating a debt ratio over one hundred percent for Taxpayer. The audit report ultimately concluded that the interest expense from the loans at issue do not fairly reflect Taxpayer's income from Indiana sources.

As a general rule, no interest is deductible in connection with transactions that have no purpose other than the securing of interest deductions. *Winn-Dixie Stores, Inc. v. C.I.R.*, 254 F.3d 1313, 1316 (11th Cir. 2001); *Lewis v. C. I. R.*, 328 F.2d 634, 635 (7th Cir. 1964). It is the taxpayer's burden to prove the existence of a *bona fide* debt. *See Lafayette Square Amoco*, 867 N.E.2d at 293. *See also Charter Wire, Inc. v. U.S.*, 309 F.2d 878, 880 (7th Cir. 1962) ("The burden of establishing that the advances were loans is upon the taxpayer.").

Taxpayer's position is that the expenses are ordinary and necessary business expenses as defined under I.R.C. § 162 and *Welch v. Helvering*, 290 U.S. 111 (1933). Taxpayer argues that the Department has misapplied the Federal arm's length statute, and that a transfer pricing study shows that the indebtedness falls within the safe haven provision of Treas. Reg. § 1.482-2. Taxpayer further argues that the Department's economic substance argument is inconsistent with Federal principles. Finally, Taxpayer asserts that a portion of the interest deducted in 2013 was related to debt that was not challenged by the Department and should therefore be allowed.

I.R.C. § 162 states that:

> (a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including–
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> (1) A reasonable allowance for salaries or other compensation for personal services actually rendered;
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> (2) Traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
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> (3) Rentals or other payments required to be made as a condition to be continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

I.R.C. § 482 provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses . . . .

Treas. Reg. § 1.482-2 further states, in relevant part:

> **(a) Loans or advances–(1) Interest on bona fide indebtedness–(i) In general.** Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.
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> . . .
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> (B) Alleged indebtedness. *This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness, even if the stated rate of interest thereon would be within the safe haven rates prescribed in paragraph (a)(2)(iii) of this section.* For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares. Similarly, this paragraph (a) does not apply to payments with respect to an alleged purchase-money debt instrument given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property. Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance.

(*Emphasis added*). Interest is only deductible from income if paid on bona fide indebtedness. I.R.C. § 163; *see Parkhill v. United States*, 385 F. Supp. 204, 207 (N.D. Tex. 1974). Thus, the first question is whether the debt which was initially structured between Taxpayer and Parent, and which was subsequently assigned to Foreign Affiliate, is a bona fide indebtedness.

1. Bona Fide Indebtedness

I.R.C. § 385(a) states, "The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." However, the corresponding regulation provides that "whether an interest in a corporation is treated for purposes of the Internal Revenue Code as stock or indebtedness (or as in part stock and in part indebtedness) is determined based on common law, including the factors prescribed under such common law." Treas. Reg. § 1.385-1.

There is no set standard in the case law that sets forth a consistent set of factors used to determine whether a transaction involves the debt or equity. I.R.C. § 385(b) states that factors in the regulations *may* include:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
(2) whether there is subordination to or preference over any indebtedness of the corporation,
(3) the ratio of debt to equity of the corporation,
(4) whether there is convertibility into the stock of the corporation, and
(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

In this instance, the Department relies upon the following eleven factors to determine whether an investment is debt or equity. These factors include (1) the name given to the documents evidencing the indebtedness; (2) the presence of a fixed maturity date; (3) the source of the payments; (4) the right to enforce payments of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of the "dividend" money; and (11) the corporation's ability to obtain loans from outside lending institutions. *Hardman v. United States*, 827 F.2d 1409, 1412 (9th Cir. 1987). No one factor is decisive, and the weight given to each factor depends on the facts and circumstances. *Id*.

An analysis of several of the factors support the audit report's finding that the loans are not bona fide debt for tax purposes. With respect to the third factor, the source of repayment of the loans is future earnings, supporting its characterization as equity and not debt. This characterization is further supported by the fact that prior intercompany loans between Parent and Taxpayer were forgiven because there were not sufficient earnings for Taxpayer to pay the interest and/or principal. The eighth factor - sufficiency of the purported debtor's capitalization - also does not support the loans' characterization as debt. For all three years of the audit, Taxpayer had negative equity, and Taxpayer's capitalization was insufficient to support a finding that the transactions were loans. With respect to the ninth factor - identity of interest between creditor and shareholder - Parent was the sole shareholder of Taxpayer at the time the advance was made, supporting a characterization of equity. Finally, the eleventh factor - ability to obtain loans from outside lending institutions - supports a finding of equity because at the end of 2011, immediately after the transfers, Taxpayer had no equity and its liabilities were 100.071 percent of its assets. It is unlikely that an unrelated third party would make such a loan under these circumstances. This is further supported by the fact that Parent previously capitalized prior unpaid loans with Taxpayer. The remaining factors either support a characterization as debt or are neutral, but do not outweigh the facts and circumstances addressed above. Taken in their totality, the above factors indicate that the loans were in fact equity and the interest was therefore not deductible as a bona fide debt.

2. Arm's Length Transaction

Even if Taxpayer could show that its expenses qualified under both parts of I.R.C. § 162(a), it has not provided sufficient documentation to demonstrate that the interest rates charged on the loans were at arm's length rates. Taxpayer purports to provide a transfer pricing study to support its position that the loans were arm's length transactions under Treas. Reg. § 1.482-2. However, the transfer pricing study provided is inapplicable to support Taxpayer's position because Taxpayer is not a party to the loans analyzed in the transfer pricing study; rather, the study analyzes transactions between Parent and a related third party. The transfer pricing study is based upon the critical assumption that Parent is the borrower, while the loan agreements at issue have Parent as the lender. Thus, Taxpayer has not provided a valid transfer pricing study to support that the transaction at issue falls within the safe haven provision of I.R.C. § 482.

In conclusion, Taxpayer has not met its burden under IC § 6-8.1-5-1(c). Taxpayer has not shown that the loans were bona fide indebtedness under I.R.C. § 163. Furthermore, even if Taxpayer could show that it qualified for the ordinary and necessary expense under I.R.C. § 162(a), it could not show that the intercompany loans were at arm's length. Thus, the Department was correct in its determination that Taxpayer is distorting its Indiana income and attempting to shift income away from Indiana. For the reasons stated above, Taxpayer's protest is denied.

FINDING

Taxpayer's protest is respectfully denied.

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